

### 3. FINDINGS AND RECOMMENDATIONS

Through our performance audit of the purchasing and contracting functions of the State of North Carolina, we identified a number of findings affecting the economy, efficiency, and effectiveness of how the State procures goods and services. Our review identified specific recommendations detailing how the State can improve its procurement activity and areas warranting additional review and evaluation or implementation in Phase II of the performance audit.

***Finding 1 - The State should have a policy for identifying contracting out opportunities.***

The State of North Carolina has a current work force of over 200,000 employees who perform a wide range of functions and activities. While some of the functions and activities are clearly of a nature that traditionally has been performed by government employees, others are candidates for contracting out to the private sector.

**Contracting out for states is a trend.** State governments are turning more and more to privatization in efforts to provide needed services without the dramatic increase in costs. And this trend is expected to continue because of the advantages offered to states. These advantages include:

- **Contracting out encourages competition.** According to Osborne and Gaebler in *Reinventing Government*, competition will not solve all our problems. But perhaps more than any other concept, competition holds the key that will unlock bureaucratic gridlock that hamstrings so many public agencies. According to Osborne and Gaebler, it has three primary advantages:
  - **Efficiency is increased.** A recent study shows that on average public service delivery is 35 to 95 percent more expensive, even without the cost of administration. In addition, by reducing personnel, North Carolina would reduce its retirement liability and ever-increasing health care costs.
  - **Public (or private) monopolies respond more efficiently.** Consider the case of the U.S. Postal Service. In 1973, prior to competition, it did not offer overnight express service. Once UPS and Federal Express began to offer this service and found a profitable market, the Postal Service followed suit.
  - **Innovation is rewarded--monopolies stifle it.** Competition requires service delivery to meet the needs of the customer. As the customer's needs change, so will delivery of the product.
- **Contracting out responds better to changing service requirements.** When demand for a service decreases, the amount of service should correspondingly decrease. When

the service is provided by the government, layoffs and disposition of assets are required. This can be both costly and time consuming. If the service is being contracted, the government can simply modify the contract upon renewal or terminate the contract. This forces the private sector to bear the burden of reorganizations and layoffs.

- **Contracting out stimulates innovation.** When services are provided by contract, the contractor can make innovations in the service delivery processes to make the process more efficient or provide better customer service. If the service is performed by the government, several levels of approval and redirection plans for current employees would typically be required. A contractor can streamline the change process.

States are even establishing special boards and commissions to look for potential privatization opportunities. By 1987 state and local governments contracted out over \$100 million dollars. For example, in Utah, a Privatization Policy Board has been established to "explore ways of using the private sector in service provision at both the state and local level."

There are several examples throughout the country of states and municipalities using privatization to lower the annual operating costs in terms of capital and labor to their constituents. These include:

- **Public Works in head-to-head competition with the private sector.** Phoenix, Arizona, is a prime example of a local government that has gone to great lengths to lower costs through privatization. According to Osborne and Gaebler in *Reinventing Government*, the local government was in the throes of fiscal crisis in 1978. In an attempt to lower costs, Phoenix put its Public Works Department in head-to-head competition for contracts to handle garbage collection, street repair and other services. The result was astonishing. Because the Public Works Department was required to compete with the private sector, it identified ways to decrease costs and be more innovative in their techniques. According to the city audit, the city saved more than \$20 million in the first 10 years. Between 1981 and 1984, it increased the number of significant contracts from 53 to 179.
- **Finding child support dollars** - Nationwide, about a third of child support dollars goes unpaid. Some states are hiring private companies to track down missing or non-paying parents. In Arizona and Nebraska, the state governments hired public relations firms to help in publicizing the effort and even enlisted the assistance of credit companies to train case workers.
- **Turning to the private sector to manage innercity schools** - The Baltimore City School System is in the process of turning over nine innercity schools to a team of private sector companies. The team will design innovative classroom instructional methods, manage the facilities, and redesign and manage the business functions.

- **Contracting sign maintenance** - Cook County, Illinois, began contracting out sign maintenance in 1980. The county officials feel that response times have been enhanced, costs have decreased, and liability has been reduced related to traffic signs.
- **Privatizing jails** - In Louisville, Kentucky, the U.S. Corrections Corporation is providing minimum security jail space for approximately 300 men for an estimated 39 percent lower cost than the local or state government could provide the same service.

North Carolina does not have a clearly established policy calling for the periodic examination of the activities and functions performed to identify if there are potential savings in costs and increased efficiency and effectiveness of service delivery if some of these functions or activities were contracted out. Conversely, some activities that are contracted out could be performed at less cost and with improved efficiency and effectiveness with government staff, especially if the work load is fairly static. In either event, the alternatives need to be reviewed periodically.

The federal government has an established program of reviewing activities to determine if contracting out of services would be more efficient. This program includes established procedures issued by the Office of Management and Budget. A basic premise of this program is that the public and private sector costs and benefits of performing a specific function or activity are consistently evaluated to determine which method of operation is the most advantageous.

The most commonly privatized services are: prisons, fleet maintenance, social services, cultural and recreational facilities, and solid waste and other environmental programs.

### **Recent developments**

The federal government has taken a significant step to encourage privatization at the state level. A recent executive order facilitates the sale to the private sector of public facilities built with federal funds. The executive order makes a further inducement to states--it decreased the share of the proceeds that would go to the federal government. The federal government will no longer receive a prorated share of the proceeds but will only receive the depreciated value of the investment. This change will have most of the proceeds going to the state and local governments.

The windfall created by this new legislation is expected to be significant. The Reason Foundation recently estimated that the order could effect up to \$220 billion dollars in assets across the nation.

**Recommendation** - We recommend that the State adopt a policy for contracting out services. That includes a clear statement of purpose and sets forth the goals and objectives, identifies opportunities, and develops a framework that assesses contracting opportunities.

### **Policy statement**

The policy should identify a strategy and assign responsibility for the program to the Office of Budget and Management. In our opinion, the first step in developing a structured program to examine the potential for contracting out is the adoption of a policy statement that:

- Defines the goals and objectives of a contracting out program
- Identifies a strategy to carry out the program
- Assigns responsibility for the program to a specific organization

### **Identify opportunities**

After adoption, the next step would be to identify the current functions and activities performed by the State that have the greatest potential to benefit from contracting out. The following questions would then be answered by the Office of Budget and Management:

- Is the service available in the private sector?
- Does the demand for the service increase/decrease?
- Can the management of the proposal ensure quality?
- Is outside labor less expensive?

Traditionally, activities such as building maintenance, equipment maintenance, transportation, printing, security, and construction inspection have been considered potential candidates for contracting out. In the organization and staffing phase of our performance audit, we discuss the potential of contracting out selected activities in the Department of Transportation.

### **Framework**

Once a function is identified, the following framework can be used to determine if functions can be contracted out:

- Identify the function(s) under study

- Establish a task group to perform the study. This group should consist of at least one member of the Purchase and Contracts Division and a member of the agency that will be using the service
- Identify the cost of the operation being performed, including:
  - Direct service costs (including salary and benefits of personnel involved)
  - Overhead costs
  - General and administrative costs
- Identify the potential cost of the contract
  - Solicit a bid and compare the annual cost of the bid to the cost of performing the function in-house. Add to this amount:
    - Additional costs of the contract, for example, transportation
    - Any one-time costs to the State, for example, the disposition of materials, severance pay, or penalties for termination of leases
- Consider the disposition of assets used in the current process.
  - Will they be transferred to another agency?
  - Will they be sold?
- Answer the question: Is contracting out financially beneficial and will it provide the highest quality product or service?

***Finding 2 - The Purchase and Contracts Division needs more timely, detailed, and useful information on purchase activity of State agencies and departments.***

Under current regulations, the Purchase and Contracts Division is responsible for issuing term contracts and for purchases in excess of \$10,000 (\$25,000 for most universities). Purchases under \$10,000, referred to as open market purchases, are made by individual agencies and departments under authority delegated to them by statute.

Currently, these agencies maintain records on their own purchase activity, using their individual agency's management information systems. These individual agency systems are not integrated with the North Carolina Automated Purchasing System (NCAPS), which is used by the Purchase and Contracts Division to accumulate purchase activity data. Some agencies report summary information on purchasing activity to Purchase and Contracts;

however, other agencies report only partial data, or, as in the case of local school districts, little or no information is reported to the Purchase and Contracts Division.

As a result, the Purchase and Contracts Division does not have complete information on:

- Agency use of term contracts
- Open market purchases that are made by agencies under their delegated authority

In the absence of this information, Purchase and Contracts is unable to carry out its responsibility to oversee purchasing activities of State departments and agencies. For example, Purchase and Contracts does not have department- or agency-supplied information on purchases made under existing term contracts to use in developing expected volume of use for these contracts during the next contract period. This information is useful to prospective vendors in making pricing policy decisions before submitting their proposals. Currently, Purchase and Contracts must obtain this information from the current contractors.

Also, information obtained on current term contracts is in summary form only for the entire contract and does not show the purchases on a line-item basis. Some term contracts, such as the contract for miscellaneous office supplies, could have several hundred line items. Therefore, prospective vendors, who may propose on only selected line items, do not know the prior purchase quantities of these line items.

The lack of information on open market purchases impedes the ability of the Purchase and Contracts Division to identify instances of:

- Large dollar amount transactions under term contracts that should have been handled as separate, specifically bid, contracts
- Small dollar value purchases that, perhaps, should be handled as open market purchases rather than under term contracts

The lack of information on open market purchases also hinders the Purchase and Contracts Division in performing oversight activities, such as:

- Identifying recurring open market purchases of groups of items that are being made in sufficiently large quantities to warrant the issuance of statewide term contracts
- Agency splitting of purchases to remain within their delegated purchase authority and to avoid processing through Purchase and Contracts Division

**Recommendation - The State should take steps to develop and implement a management information system on purchase activity by State departments and agencies to provide the Purchase and Contracts Division with information on**

commodities purchased on the open market or under term contract by State agencies and departments. The Purchase and Contracts Division needs this information to determine expected volume of purchases, by line items, for new term contract solicitations, for use in oversight of the use of term contracts, and open market purchases by agencies and departments. Currently, the Controller's Office is studying the potential for a new accounting system. The implementation of the purchasing system is currently on hold. Although the new system contains a purchasing component, it is considered to be a low priority. With this in mind, we recommend that the installation of a new purchasing system be increased in priority and that the Purchase and Contracts Division be included in the implementation process.

***Finding 3 - The Purchase and Contracts Division has not aggressively pursued innovative purchasing practices.***

The State purchasing program is based on a philosophy that requires advanced planning to provide the broadest scope of purchasing at lowest cost and maximum effectiveness. To achieve this, the State must take an aggressive role in identifying and instituting innovative practices. A materials management and total supply concept should be used. Under this premise, purchasing is not simply a routine housekeeping function. Rather, it is the sophisticated management of goods and services based on meeting the needs of the customer by procuring goods at the lowest prices while minimizing inventories and associated operating costs. This is done through centralized purchasing management and active identification and implementation of innovative purchasing practices.

While we identified several examples of innovative purchasing methods, these practices were being developed almost exclusively at the departmental level. For example:

- The Department of Human Resources has developed a plan to purchase drugs through a prime vendor that will act as a middleman and will maintain inventory, seek the lowest available price for approved drugs, and distribute them to State facilities on an as-needed basis, thereby decreasing inventory carrying costs.
- North Carolina State University, among others, is using Electronic Data Interchange (EDI) to purchase commodities. Under this technology, orders are placed with vendors electronically via modem, which results in shorter lead time, reduced administrative costs, and greater assurance that contract pricing is current. This practice is primarily used for commodities that are purchased on a regular basis.

The potential impact of instituting these two programs statewide is substantial. For instance, the Department of Human Resources performed an analysis at a single hospital for cost savings under the prime vendor method of procurement. The current drug costs of the hospital were \$530,000. Under the prime vendor method, it was estimated that costs could be reduced by nearly 30 percent, for a savings of \$160,000.

Using EDI, savings would be realized through decreased work load and by using the most accurate and up-to-date vendor pricing information. The use of an EDI system would reduce the cost of preparing hard-copy purchase documents and speed up the purchase order time by eliminating the delay in mailing documents to the vendor. In addition, pricing information on EDI is electronically updated so billing and payment errors can be avoided. However, no plans have been made to introduce the concept to other agencies.

In each of these cases, the concept was developed at the department or agency level and has generated savings and improved efficiency. The Department of Human Resources recommended the adoption of the prime vendor concept to the Purchase and Contracts Division.

**Recommendation - We recommend the Purchase and Contracts Division take the lead in aggressively developing innovative procurement practices** that will reduce the cost of ordering supplies and services, reduce the volume of inventory maintained by the departments, and increase the quality of products purchased. These improved practices could result in:

- **Reduced inventories** - As of June 30, 1991, the inventory levels of State agencies and departments, including the universities, was about \$145 million. If the State were to adopt additional purchasing practices such as prime vendors statewide, modeled after Just-in-time concepts, significant savings would result. Just-in-time concepts strive to reduce inventories to their lowest possible levels, thereby reducing inventory carrying costs. Under this method, material is ordered from prime vendors for delivery at the time it is needed as opposed to ordering for stock. For example, if the method were implemented statewide and inventory levels were reduced by \$45 million (slightly more than the 30 percent used as an estimate of inventory reduction under a Just-in-time system), the estimated savings in inventory carrying costs would be approximately \$5 million. These savings are based on the University of North Carolina at Chapel Hill, which estimates that the cost of storing and issuing inventory is about 12 percent of the value of the inventory.
- **Streamlining and reducing the cost of ordering** - It is becoming a common business practice to order supplies through use of EDI. Under this technology, orders are placed with vendors electronically, which results in shorter lead-time, reduced administrative costs, and greater assurance that contract pricing is current. This technique is currently being used, to a limited extent, by North Carolina State University, for purchase of laboratory supplies. We believe that the Purchase and Contracts Division should identify other opportunities to use this method of ordering. Some potential vendors include:
  - Office supply vendors



- Paper supply vendors
- Food vendors
- Drug vendors

***Finding 4 - The State should increase the use of single prime contractors on capital projects.***

There are two primary methods of contracting for construction of capital projects - a single prime contractor method, wherein a single contractor has overall responsibility for a project and uses subcontractors for key components of the project; and a multi-prime contractor method, in which each major component contractor (e.g., general, heating, ventilation, and air conditioning; plumbing; and electrical) is a prime contractor. The multi-prime method of contracting for public projects is not the common practice among state governments and the private sector. The prime vendor method is the prevailing method used. We were advised that New York is the only other state that uses a multi-prime contracting method.

Prior to 1989, North Carolina statutes required bidding of capital projects exceeding \$100,000 to have separate specifications for the following subdivisions or branches of work:

- General construction
- Heating, ventilation, and air conditioning
- Plumbing and gas
- Electrical wiring and installation

This requirement resulted in the State having a prime contractor for each of these subdivisions or branches of work, and is referred to as the multi-prime method of contracting.

The 1985 Governor's Efficiency Study Commission report concluded that the current State of North Carolina practice of using multiple prime contractors for capital projects makes it difficult to delegate responsibility, coordinate work, and resolve conflicts. The commission recommended that amending State statutes to permit designation of a single prime contractor would enhance overall project management and help reduce cost overruns. The study estimated that the reduction in contract change orders and earlier project completion could result in annual savings reaching \$1 million.

The State Construction Office responded to the study commission recommendation and substantially concurred with the amount of estimated savings that would result in using a single prime contractor. The then director of the State Construction Office expressed the

view that the proposed change would be strongly opposed by contractor groups that would be affected by the change of status. Also, the director stated the view that documentation of any actual savings would not be possible.

### **Existing legislation**

In 1989, in response to the commission's report, legislation that authorized the use of a single prime contractor for capital projects was enacted. Under this legislation, the State may use a single prime contractor as an alternative to multi-prime contractors. Under the single prime contract arrangement, a single prime contractor would have overall responsibility for a project and other contractors would be subcontractors. The legislation required, however, that if the State chose to use the single prime form of contract, it must also seek bids under the multi-prime method of contracting and award the contract to the lowest bidder or bidders for the total project.

The legislation provided that the State would monitor and study the multi-prime and single prime contracts and compile data on the total verifiable contractual, legal, and administrative cost to the public. The legislation also provided that an analysis of the impact of the change in method of contracting would be provided to the 1995 session of the General Assembly. The State Construction Office developed reporting procedures to gather information on the multi-prime and single prime contracts that were being issued.

An analysis of the reports on public contracts awarded since the legislation was enacted through the period ending December 31, 1991, is shown in Exhibit 3-1. This analysis shows that although about 30 percent of the total contracts awarded have been single prime contracts, less than 15 percent of the dollar value of contracts has been awarded to single prime contractors. Of the 524 total contracts awarded during the period and valued at approximately \$401 million, only 29 contracts, or about \$19 million, were awarded to single prime contractors, when contracts were solicited from both single prime contractors and multi-prime contractors.

### **Multi-prime contracting is the prevailing method**

Summary comments included by the reporting agencies reflected views that the multi-prime contracts required extensive agency supervision, resulting in higher administrative and legal costs. In addition, the view was expressed that multi-prime contracts discouraged many minority firms from participating in the contracts, since they could not obtain bid bonds and other needed insurance.

Our discussions with agency officials also indicated that the use of the multi-prime method of contracting for public projects is not the prevailing practice by state governments or the private sector. In their view, the legislative requirement that State agencies must obtain bids on both a multi-prime and a single prime contract basis creates a situation where multi-prime contracts have an advantage unless multi-prime contractors reduce their proposed

**EXHIBIT 3-1**  
**Summary of Awards of Multi-prime (MP) and**  
**Single-prime (SP) Contracts**

	Total		Multi-Prime		Single	
	Number of Projects	Contract Amount	Number of Projects	Contract Amount	Prime Projects	Contract Amount
Bid as MP only, <\$1.5 million	241	\$ 99,434,432	241	\$ 99,434,432		
Bid both ways, awarded as MP, <\$1.5 million	33	16,908,290	33	16,908,290		
Bid as MP only, >\$1.5 million	56	175,345,021	56	175,345,021		
Bid both ways, awarded as MP, >\$1.5 million	36	55,764,539	36	55,764,539		
Bid as SP only, <\$1.5 million	125	21,950,057			125	\$21,950,057
Bid both ways, awarded as SP, <\$1.5 million	22	6,034,868			22	6,034,868
Bid as SP only, >\$1.5 million	4	13,577,894			4	13,577,894
Bid both ways, awarded as SP, >\$1.5 million	7	12,603,810			7	12,603,810
<b>TOTAL</b>	<b>524</b>	<b>\$401,618,911</b>	<b>366</b>	<b>\$347,452,282</b>	<b>158</b>	<b>\$54,166,629</b>
<b>PERCENTAGE</b>			<b>69.85%</b>	<b>86.51%</b>	<b>30.15%</b>	<b>13.49%</b>